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In the Supreme Court of the United States

OCTOBER TERM, 1958.

No. 765

CHARLES J. GREGORY, ET AL., PETITIONERS

v.

THE COLUMBIA GAS SYSTEM, INC., ET AL.

No. 766

PAUL E. KERN, PETITIONER

v.

THE COLUMBIA GAS SYSTEM, INC., ET AL.

No. 774

ELMO E. ALLEN, ET AL., PETITIONERS

v.

THE COLUMBIA GAS SYSTEM, INC., ET AL.

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE SECURITIES AND EXCHANGE COMMISSION

OPINIONS BELOW

The opinion of the court of appeals (Kern 28b–30b)[1] is not yet reported. Earlier opinions of the

[1] "Kern" refers to the petition in No. 766; "Gregory," to No. 765; and "Allen," to No. 774.

court of appeals relevant to this proceeding are reported at 151 F. 2d 461 (partially set forth at Allen 21–28); 187 F. 2d 813 (partially set forth at Allen 30–33); and 241 F. 2d 374 (Kern 7b–27b).

JURISDICTION

The judgment of the court of appeals was entered on January 15, 1959. The petitions for writs of certiorari were filed on March 13 (Nos. 765 and 766) and 14 (No. 774), 1959. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether in a reorganization under Chapter X of the Bankruptcy Act an unsecured creditor may be allowed post-petition interest before compensation of a creditor subordinated to it because of inequitable conduct. That question turns upon:

   (*a*) Whether general bankruptcy principles preclude payment of post-petition interest to an unsecured creditor before payment of creditors junior to it in priority.

   (*b*) Whether, if so, the general bankruptcy principles are applicable to Chapter X reorganizations.

   (*c*) Whether, regardless of the interest rules applicable to contractual priorities, a reorganization court may, under its general equitable powers, subordinate the claims of a wrongdoing creditor to the claims of other creditors for post-petition interest as well as for principal.

2. Whether the claims of the wrongdoing creditor in this case should have been rejected entirely and, if

not, whether the court has power to subordinate them in part to the interests of public stockholders as well as to claims of creditors.

STATUTE INVOLVED

Pertinent provisions of the Bankruptcy Act (52 Stat. 840, 11 U.S.C. 1, *et seq.*) are set forth at Kern 1b–6b.

STATEMENT

This case arises out of proceedings under Chapter X of the Bankruptcy Act (11 U.S.C. 501, *et seq.*) involving the debtors Inland Gas Corp. ("Inland"), Kentucky Fuel Gas Corp. ("Kentucky"), and American Fuel and Power Co. ("American").[2] The Securities and Exchange Commission is a party to the proceedings pursuant to § 208 of the Bankruptcy Act (11 U.S.C. 608). These proceedings are a continuation of proceedings under former § 77B of the Bankruptcy Act, which in turn succeeded equity receiverships of the debtors that had been instituted in 1930 and 1931.

It has previously been established that the receivership proceedings had been caused by Columbia Gas and Electric Corporation (since renamed the Columbia Gas System, Inc. and referred to herein as "Columbia"), a respondent in each of the petitions. Columbia had obtained control of the debtors in order to prevent their competition with certain of Columbia's subsidiaries. See *Columbia Gas & Elec-*

[2] Problems arising in these proceedings were considered by this Court in *Vanston Bondholders Protective Committee* v. *Green*, 329 U.S. 156. See also *Columbia Gas & Electric Corp.* v. *American Fuel and Power Co.*, 322 U.S. 379.

tric Corp. v. *United States,* 151 F. 2d 461. The opinion in that case, approving numerous findings of the district court, is (unless otherwise indicated) authority for the facts set forth in this memorandum.

Inland and Kentucky were incorporated in 1927 and 1928, respectively, to produce natural gas and acquire gas properties. They were financed by the public sale of their debt securities. American was organized in 1928 as a holding company to consolidate operations and management. Its debt securities were also sold to the public and its common stock was exchanged for common stock of Inland and Kentucky. These companies, together with several small corporations wholly owned by American Fuel, constitute the American Fuel system, which has at all times been operated as an integrated enterprise.

Prior to the organization of this system, Columbia had virtual freedom from competition in the field occupied by its subsidiaries in Kentucky, Ohio, and West Virginia. Thereafter it lost certain of its large industrial customers to the American Fuel system. In January 1930, having noted that Inland and Kentucky Fuel had sustained substantial operating losses and that default upon their bonds might be anticipated, Columbia began to purchase Inland and Kentucky bonds on the open market, so that it would be in a position to force foreclosure and sale of their properties. These purchases continued until Columbia had acquired in excess of 25% of the bonds of both companies.

Meanwhile, Hope Engineering Co., which had been supervising and managing the operations of Inland

and Kentucky Fuel, determined that the only hope of survival of the American Fuel system was by financing a large expansion of its business. Together with two other companies, it formed a syndicate to construct a natural gas transmission line to Detroit, which was not then served with natural gas. The syndicate agreed to provide funds sufficient to prevent immediate default on the obligations of American, Inland, and Kentucky. The syndicate acquired a majority of American's common stock, giving it control of the system. As the court below previously noted (151 F. 2d 461, 464): "The Syndicate was considered to be a combination of sufficient financial strength and business experience to foreshadow success of the Detroit project and so prevent the impending financial collapse of the American Fuel System."

Shortly thereafter, Columbia, which had also planned to supply natural gas to the Detroit area, purchased the syndicate's entire holdings in the American Fuel system, giving the syndicate a clear profit of $350,000, as well as agreeing to hold its members harmless by reason of obligations they had undertaken, and otherwise obligating itself to Hope Engineering Company in a manner which it ultimately settled by the payment of $400,000. Upon obtaining control, Columbia brought about receivership proceedings and the American Fuel system's Detroit project was abandoned.

The court below found "that the Detroit line would have served American Fuel and its subsidiaries, and in its successful completion lay their only hope for escape from impending financial disaster." 151 F.

2d at 468. It added (*id.* at 469): "The prospect of recovery and possible profit in what may now seem to have been initially an improvident investment by security holders, lay in the achievement by American Fuel and its subsidiaries of an expanded market to be opened up by the Detroit pipeline. The realization of their hopes was forever destroyed by the activities of Columbia in assuming control of the American Fuel system, terminating further pursuit of the Detroit plan and placing the companies in receivership."

By reason of Columbia's activities, the court determined that its securities must be subordinated to those of other creditors of every class of the American Fuel system (*id.* at 470). The instant petitions raise questions as to the maximum limits of this subordination.*

Substantially all the physical assets in the system are those held in Inland. 72.6% of Inland's stock is held by American; 26% by Kentucky; and 1.4% by public stockholders. In recent years, Inland's properties have greatly increased in value. Inland's first mortgage bonds, other than those held by Columbia, have been paid in the amount of approximately $2,650,000 principal and $2,600,000 interest. Also, more recently, the holders other than Columbia of Inland's debentures and gold notes, secured by a second

The court had earlier indicated that Columbia's claims should be rejected (122 F. 2d 223) but later directed subordination instead (151 F. 2d 461). The extent of the subordination of Columbia's securities has been involved in *Columbia Gas & Electric Corp.* v. *United States*, 153 F. 2d 101, certiorari denied, 329 U.S. 737; *In the Matter of Inland Gas Corp.*, 187 F. 2d 813; and *In re Inland Gas Corp.*, 211 F. 2d 381, certiorari denied, 348 U.S. 840; *In re Inland Gas Corp.*, 217 F. 2d 207.

mortgage, have been paid in full by payments of approximately $1,530,000 principal and $2,236,000 interest. In addition, during the course of the proceeding, approximately $870,000 in interest was paid on the publicly-held bonds of American and approximately $400,000 was paid on Kentucky's bonds, which latter payment for purposes of the current plan has been treated primarily as a payment on account of principal.

As of December 31, 1957, assuming interest at the contract rate, the claims of the publicly-held bonds and debentures of Kentucky consisted of $2,448,701 principal and $4,343,716 interest. The claims of the publicly-held American bonds and debentures consisted of $1,905,100 principal and $2,800,497 interest. Columbia has claims against Inland consisting of $2,143,367 principal and $3,646,083 interest, as well as substantial claims against American and Kentucky. The total claims against the several companies are tabulated in the Appendix, *infra*, p. 30.

The decision of the court below dismissed appeals from an order of the district court (Gregory 1a–3a) confirming a plan of reorganization and affirmed the judgment of the district court (Kern 28b–30b). The plan provides for (*a*) payment to the public security holders of American of principal and interest on their claims to the date of payment; (*b*) payment of principal on the claims of Kentucky's public security holders but no interest except for $17,615 in default prior to the receivership; and (*c*) the balance of the estate to go to Columbia through the issuance of new common stock in a reorganized company. No participation is accorded to the 1.4% of Inland stock

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which is publicly held or to public stockholders of American. The plan is predicated upon a valuation accepted by the court of $10,538,781 for Inland, as at December 31, 1957, which, together with certain assets of American, makes a total valuation somewhat in excess of $11,000,000[4] (S.E.C. Corp. Reorg. Rel. No. 109 (1958), pp. 15, 18–30).

In dismissing the appeals from the order of the district court, the court below stated that the district judge properly applied the principles stated in the court's opinion at 241 F. 2d 374 (Kern 29b), from which Chief Judge Simon had dissented.

DISCUSSION

I

In the earlier proceedings in this case, the court below had held that the public Kentucky creditors (bond and debenture holders) were to be treated as unsecured creditors of Inland and that the claims of Columbia against Inland, although not rejected, were to be subordinated to their claims (as well as to those of American's public creditors). Accepting the case in that posture, the holding on the present appeal that the Kentucky creditors are to receive only principal before the subordinated claims of Columbia are paid presents, we believe, questions of fundamental importance to the administration of Chapter X reorganization proceedings.[5]

[4] The Commission's over-all system valuation as at that date was approximately $1,000,000 higher than that adopted by the court.

[5] These questions were involved in petitions to this Court in the October 1957 Term, which were denied at 355 U.S. 838. At that time we noted that the judgment of the court of appeals

Relative priorities among unsecured creditors were seldom encountered in the historical development of bankruptcy law—creditors of both individuals and corporations were traditionally either secured or unsecured and sub-priorities typically existed only among the secured class (lienholders, first and second mortgagees, etc.). Today, however, relative priorities among unsecured creditors are encountered with increasing frequency, not only, as here, through the application of the equitable remedy of subordination but, even more importantly, through the increased use of contractual priorities in corporate financial structures (*e.g.*, the issuance of senior and junior unsecured debentures).[4] Thus, the question of the relative rights in reorganization proceedings of unsecured

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sought to be reviewed, insofar as it dealt with the question of post-petition interest, was "undoubtedly 'non-final' in the sense that the decision contemplates a remand for purposes of formulation of a new plan." Memorandum for the Securities and Exchange Commission, Nos. 241, 325, 336, 342, October Term, 1957, p. 17. We also stated that there was some doubt "whether the question of subordinating Columbia's claims to stockholder claims" (see Point II, *infra*) was "properly presented," pointing out that there was "no basis for assuming that the court below passed on any question relating to the relative priorities of Columbia and the stockholders." *Id.* at 22.

[4] See, *e.g.*, *Columbia Gas System, Inc.*, 35 S.E.C. 552, 566–567 (1954). See also § 302(a) of the Small Business Investment Act of 1958, 72 Stat. 692, empowering the Small Business Administration to purchase the debentures of authorized small business investment companies, which debentures "shall be subordinate to any other debenture bonds, promissory notes, or other obligations which may be issued by such companies * * *."

creditors of different priorities is one of recurring, and growing, importance.

The basis for the decision below was that (1) under traditional bankruptcy rules an unsecured creditor was not entitled to interest accruing after the date of the bankruptcy petition ("post-petition interest") even before payment of creditors junior to it in priority; (2) the same rules apply to Chapter X reorganizations; and (3) the fact that the junior creditor here was one whose claims had been subordinated for inequitable conduct does not permit the usual interest rules to be varied. While we question the validity even of the first proposition, it is with the latter two that the Commission, in its participation in reorganization proceedings, is primarily concerned, and of those we believe that neither is sound.

1. The starting point for the court's decision was that under the "common law" bankruptcy rule an unsecured creditor, even if having a contractual priority over other unsecured creditors, was not entitled to the payment of post-petition interest prior to the payment of other creditors. Since in our view special considerations are applicable to this question in Chapter X reorganization proceedings (see *infra*, pp. 14–19), what the common-law rule may have been is not, we think, controlling. It is important to note, however, that the court's view of the common law is at best highly dubious and there is little, if any, evidence that the common-law interest rule was ever so applied to creditors of different rank.

Interest is of importance in bankruptcy for its effect upon both "intra-class" rights and "inter-class"

rights, and the two problems are entirely distinct. When creditors of equal priority claim a fund which is insufficient to satisfy their claims in full, the "interest" question is simply whether the fund should be divided among them in proportion to their principal claims or in proportion to their claims for principal plus post-petition interest. To the extent that interest accrues on the several claims at different rates, allowance of interest would cause a continuous (though relatively insignificant) change in the ratio of the claims to each other and hence in the creditors' proportional participation. Disallowance of interest for that purpose would avoid the continuous recomputation of the proportional rights in each distribution and would normally not affect substantial rights, particularly during a short period of administration. In effect, it would simply give priority, within the class as a whole, to the debts accrued on the date of bankruptcy. In determining "inter-class" rights, however, the question is one of the respect to be accorded the contractual priorities between the classes—*i.e.*, whether a junior class may participate in the assets before a senior class has been compensated in full by payment of both principal and interest to the date of payment.

The traditional bankruptcy rule is normally stated as being that interest does not accrue after the date of bankruptcy, without distinction being made between intra- and inter-class questions. We believe, however, that an examination of the historical development of the rule will show that it has been consistently applied only in determining intra-class rights and that there is

no established body of precedent disallowing post-petition interest as between classes of different priorities.

The explanation of that result is that, while the "rule" has been stated in absolute terms, "exceptions" to it have been recognized whenever application of the rule would impair priorities and affect inter-class rights. The established exceptions to the rule allow post-petition interest to be paid (*a*) to secured creditors to the extent of their security (and hence of their priority) and (*b*) to unsecured creditors before any payment is made to the bankrupt or the stockholders. *New York* v. *Saper*, 336 U.S. 328, 330 n. 7; *Ticonic National Bank* v. *Sprague*, 303 U.S. 406, 413. Within the class of secured creditors, moreover, interest is allowed to a senior lienor before participation by a junior lienor. *R.F.C.* v. *Denver & Rio Grande W. R. Co.*, 328 U.S. 495, 502–503 n. 6, 517. Post-petition arrearages on cumulative preferred stock are also allowed in reorganizations before participation by common stockholders. E.g., *Petition of Portland Electric Power Co.*, 162 F. 2d 618 (C.A. 9), certiorari denied, 332 U.S. 837. From these exceptions, therefore, it is established that the order of payment to security holders under traditional bankruptcy principles is:

(a) principal, then interest, to senior secured creditors;

(b) principal, then interest, to junior secured creditors;

(c) principal, then interest, to unsecured creditors;

(d) liquidation preferences and arrearages to preferred stockholders; and

(e) common stockholders.

Since, as noted above (p. 9), that order of payment encompasses all of the general priorities among security holders normally involved in bankruptcy, it is apparent that the general scheme of distribution under the traditional rules, whether denominated "exceptions" or otherwise, gave full recognition to contractual priorities in the allowance of post-petition interest. While it is true that there is no established "exception" specifically allowing interest to the senior of two classes of unsecured creditors having different contractual priorities (*e. g.*, senior and junior debentures), it is equally true that there is no established body of law denying interest in that context.

In holding that an exception could not be recognized to allow interest as between unsecured creditors of different rank, the court below relied solely on this Court's decision in *New York* v. *Saper*, 336 U.S. 328, that post-petition interest was not allowable on tax claims given statutory priority. The question was there presented to the Court, however, solely in terms of whether tax claims were entitled to special treatment in that respect under the applicable statutes, or whether Congress intended, by a change in the Bankruptcy Act, to assimilate such claims, for purposes of post-petition interest, to the status of ordinary debts in bankruptcy (*i.e.*, with the statutory priority being limited to the amount of the claim on the date of bankruptcy). If the opinion reflects an assumption that a private creditor having a general contractual priority would not be entitled to interest before payment of junior creditors (though it does not allude to that problem), it is a sufficient explan-

ation, we submit, that that question was neither argued to the Court nor expressly discussed by it. In any event, the question whether a priority imposed upon the estate by statute should be extended to include post-petition interest turns on considerations quite different from those involved in protecting priority rights bargained for by the investing public or arising from subordination of a creditor because of inequitable conduct. The *Saper* case cannot be read as having resolved the latter questions.

In our view, therefore, there is no established rule of bankruptcy compelling the disallowance of post-petition interest between unsecured creditors of different contractual priorities. Without debating which is in reality the "rule" and which the "exception," we submit that the disallowance of interest was firmly established as a "fundamental principle" (*Sexton* v. *Dreyfus*, 219 U.S. 339, 344) only in allocating a limited fund among creditors of equal rank and that contractual priorities between classes of creditors were generally recognized by the allowance of post-petition interest to senior claimants before payment of junior claimants. What the rule should be in determining the respective rights of unsecured creditors having different priorities is an open question.

2. Even assuming, however, that the traditional bankruptcy rule would have denied post-petition interest to a senior unsecured creditor, there remains the important question whether that rule, developed in the context of straight bankruptcy, has any application to reorganizations under Chapter X. See, *e.g.*, Note, ***Post-Bankruptcy Interest in Chapter X Reor-***

ganizations, 67 Yale L.J. 1131; Note, *Allowance of Post Petition Interest During Reorganization Proceedings Under Chapter X of the Bankruptcy Act,* 33 N.Y.U.L. Rev. 863; 6 Collier, *Bankruptcy* (14th ed.) ¶9.08; Finletter, *The Law of Bankruptcy Reorganization,* 300–303 (1939).

The fundamental distinction between bankruptcy and Chapter X reorganizations is that bankruptcy is directed to liquidation while reorganization looks to the continuation of the business. The purpose of bankruptcy is the winding up of the debtor's business and its discharge from creditors' claims. There is no machinery for maintaining the business as a going concern, and the sole object is the prompt liquidation of the bankrupt's assets and the distribution of the proceeds among the creditors. Distributions are made periodically as cash is realized; final distribution of the assets is normally made within a comparatively short period after the institution of the proceedings; and the creditors often receive but a small fraction of their claims.

Reorganization under Chapter X, on the other hand, looks to the corporation's rehabilitation and the preservation of the business as a going concern. The business continues to be operated under trusteeship during the reorganization and may produce, as here, a substantial increase in the debtor's assets. Some period of operation is necessarily required for an appraisal of the business' earning power and of the feasibility of reorganization, and the period of administration is frequently of prolonged duration.

There are many respects in which the differences

between the two kinds of proceedings make the reasons for the bankruptcy interest rule inapplicable to reorganizations. Thus, Mr. Justice Holmes' justification of the rule denying post-petition interest in bankruptcy that it "simply fixes the moment when the affairs of the bankrupt are supposed to be wound up" (*Sexton* v. *Dreyfus*, 219 U.S. 339, 344) can have no application to a reorganization the purpose of which is to continue the business rather than wind up its affairs. So also the "administrative inconvenience of continuous recomputation of interest" which has been suggested as a reason for the denial of post-petition interest in bankruptcy (*Vanston Bondholders Protective Committee* v. *Green*, 329 U.S. 156, 164) arises from the requirement in bankruptcy of periodic distributions as assets are converted to cash, a requirement not applicable in reorganizations.

The most important, and in our view controlling, difference, however, is that the debtor's assets in bankruptcy constitute a "dead fund" (*Ex parte Bennet*, 2 Atk. 527 (1743)) which is to be simply liquidated and divided among the creditors. The assets are normally unproductive during the delay incident to liquidation, and it is perhaps not unreasonable to require the burden of delay to be borne equally by all the creditors by not allowing interest to any. If interest were allowed, the delay would simply change the distribution of the fund without increasing its size. In reorganization, however, the assets which would in bankruptcy have been distributed outright to the senior creditors are retained by the trustee and used to continue the business in operation during the

reorganization. Profits earned during that operation will be available for other creditors and the losses, if any, must be borne by the senior creditors, all of whose claims might have been satisfied by an immediate liquidation of the business. In this context interest is in no sense a "penalty" for the delay in payment but is simply fair compensation to the senior creditors for the productive use by the estate of the assets owing to them.

That the denial of interest during reorganization proceedings is manifestly unfair to the senior creditors is fully demonstrated by the facts of this case. Five years ago, a plan was finally approved under which Columbia was to receive nothing on its subordinated claims and the residual estate was to have gone to the Kentucky Fuel creditors. Because of an increase in the value of the estate pending the appeals from the plan, the plan was never consummated. Under the present plan, the Kentucky Fuel creditors, whose claims have gone unpaid for almost thirty years, are to receive no interest for the intervening period, and Columbia is to receive, on its subordinated claims, the primary benefit of the increase of assets resulting from the continued operation of the business since the last plan was approved.

For these reasons, it is our view that at least in reorganizations—even if not in straight bankruptcy—the rule of absolute priority, requiring that each security holder be compensated for his "entire bundle of rights" before juniors may participate, makes it essential that post-petition interest be given "the

same priority as the principal." *Consolidated Rock Products Co.* v. *Du Bois,* 312 U.S. 510, 527, 528. While that case in fact involved secured creditors, the absolute priority rule applies equally to all levels of priorities and it is immaterial whether the priority arises by virtue of security or otherwise. Any other rule would make the rights of a class of creditors depend upon the nature of the claims junior to it. A debenture-holder would be entitled to post-petition interest during the reorganization if followed in priority only by stockholders but would not be if followed by junior debenture-holders. Allowing the creation of a junior debenture issue so to alter the rights of the senior debenture-holders would, we submit, be a clear violation of the absolute priority rule.

The question of the application of bankruptcy rules to Chapter X reorganizations has never been expressly considered by the Court and remains unresolved. In *Group of Investors* v. *Milwaukee R. Co.,* 318 U.S. 523, 573, the Court, in dealing with one minor issue in the case, assumed without discussion the applicability to Chapter X reorganizations of the bankruptcy rule disallowing interest in apportioning a limited fund among a single class of creditors (*i.e.,* in determining intra-class rights). In *Vanston Bondholders Protective Committee* v. *Green,* 329 U.S. 156, 163–164, the Court, in holding that the allowance of interest on interest in a Chapter X proceeding would be inequitable, implied in dictum that the bankruptcy interest rules were equally applicable to such proceedings, but again without express consideration of the possible differences

between the two kinds of proceedings and also without adverting to the particular problem of the treatment of interest between creditors of different priorities. The only decision of the Court actually disallowing interest on a claim of senior priority in a Chapter X reorganization is the per curiam decision in *United States* v. *Edens*, 342 U.S. 912, disallowing interest on a tax claim on the authority of *New York* v. *Saper, supra*. As noted above in the discussion of the *Saper* case (*supra*, pp. 13–14), the problem of interest on tax claims involves considerations quite distinct from those involved in preserving contractual priorities, and the decision in *Edens* cannot be taken, we believe, as resolving the general question of the applicability of bankruptcy rules to reorganization proceedings in other contexts.

3. Finally, whatever may be the proper rule as between creditors of different contractual priorities—by which the court below thought itself bound—there remains a question whether the equitable remedy of subordination is flexible enough to permit a wrongdoing creditor to be subordinated to other creditors' claims for interest as well as to their claims for principal. Whether there is such a limitation on the power of subordination is of substantial importance in reorganization and bankruptcy proceedings, since problems whether and to what extent the securities of controlling persons should be subordinated arise with considerable frequency. They are bound to recur whenever a parent owns securities in its subsidiaries

of a superior or equal rank to those held by the public.'

In *Pepper* v. *Litton*, 308 U.S. 295, 305, it was made clear that the remedy of subordination, like other equitable remedies, is "invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." Subordination is used to undo so far as possible the wrong committed when a controlling person uses "his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements." *Id.* at 311; see also *Taylor* v. *Standard Gas & Electric Co.*, 306 U.S. 307. As this Court stated in *Sampsell* v. *Imperial Paper & Color Corp.*, 313 U.S. 215, 219, "The power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors is complete." See also *American United Mutual Life Insurance Co.* v. *City of Avon Park*, 311 U.S. 138, 146.

It is established by the prior proceedings in this case that Columbia's improper activities in prevent-

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[1] See, *e.g.*, cases cited at 3 Collier on *Bankruptcy* (14th ed.) ¶ 57.14, notes 6–7; ¶ 65.06, notes 1–2; 6 *id.*, ¶ 9.15, note 16. The extent of the application of this remedy is by no means fully reflected in the reported cases, since, in various Chapter X cases where there is no court opinion, approved plans reflect a determination or compromise of contentions that a parent's claim must be subordinated. Problems of subordination have also arisen frequently in reorganizations under Section 11 of the Public Utility Holding Company Act of 1935.

ing the opening of the Detroit market for the gas produced by the system companies put an end to their hope of profits and hence adversely affected all security holders of the system. Nevertheless, the court below deemed itself bound by the bankruptcy rules of interest to allow control of the enterprise to be returned to Columbia (by issuance of common stock in compensation for its subordinated claims against Inland) without interest having been paid to the public security holders of Kentucky—who have received substantially no interest since Columbia's inequitable activities—and without any determination having been made that the payment of principal alone to those creditors adequately compensates them for the harm inflicted by Columbia's inequitable conduct. It is our contention that, whatever the general rules of interest might be, the remedy of subordination is not so mechanical that that unjust result is required. Rather, the remedy is "complete" and the extent of subordination may vary depending on what is equitable under the circumstances. Just as subordination may be to less than the full principal of the injured creditors' claims where the maximum injury is ascertainable at some lesser amount (*e.g., In re Kansas City Journal-Post Co.*, 144 F. 2d 791, 800 (C.A. 8)), it may also be to the full amount of both principal and interest where the entire claims have been jeopardized by the parent's overreaching.

In denying its power to allow post-petition interest to unsecured creditors even as against a creditor subordinated to them because of wrongful conduct, the decision of the court below is in direct conflict with

the decision of the Tenth Circuit in *In re Deep Rock Oil Corp.*, 113 F. 2d 266, certiorari denied, 311 U.S. 699, a reorganization case which arose under former Section 77B of the Bankruptcy Act. There, on prior review in *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307, by reason of the wrongful management and exploitation of the debtor by the parent (Standard), this Court had reversed a lower court judgment approving a compromise plan under which public security holders were not participating in full prior to participation by Standard on an open account. On remand, Standard contended that, even as a subordinated creditor, it should participate in Deep Rock's assets since there was an equity for it of over $2,000,000 if the paramount position of the public noteholders and preferred stockholders should be limited respectively to the principal amount of the debt and the liquidating value of the preferred stock. In holding that Standard's claims were subordinated to both the interest and dividend arrearages, the Court of Appeals made clear that the noteholders were to be paid interest to the time of payment. In the instant case, Judge Miller, speaking for the majority, recognized that the *Deep Rock* case "lends some support" to the contention of the Kentucky Fuel creditors but stated that "such a contention appears to me to be expressly rejected by the Supreme Court in the City of New York v. Saper, supra, 336 U.S. 328." Quite apart from the other distinctions of the *Saper* case already suggested, it is clear that that case in no way involved equitable subordination or implied any limits on that power.

4. A final aspect of the decision below demonstrating the inequitable results of the court's mechanical application of the "bankruptcy rule" and its "exceptions"—although perhaps not in itself raising questions of general importance—is that it in fact *allows* post-petition interest to Columbia while denying it to the claims to which Columbia was subordinated.[8] That result was achieved on the ground that Columbia, although subordinated, was a "secured" creditor (its subordinated claims having been mortgage bonds) and thus came within the "exception" to the bankruptcy rule allowing interest to secured creditors. The underlying principle of that exception—the recognition and protection of *priorities*—is thus ignored and the allowance of interest is made to depend upon a characterization of the nature of the creditor's claim. Columbia is allowed interest because its claim was nominally "secured," notwithstanding that the other creditors have been given prior rights even to Columbia's security. In fact, of course, Columbia's security has been denied it for all practical purposes and the only remaining consequence of the security is unaccountably to entitle Columbia to interest prior to the dominant creditors.

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[8] As noted at p. 7, *supra*, the principal amount of Columbia's claims against Inland totals $2,143,367. Columbia, being the recipient of the residual equity under the plan, will receive securities valued by the district court at approximately $3,000,000, by the Commission at approximately $4,000,000 and by other experts at an amount beyond Columbia's total claims against Inland for both principal and interest. See S.E.C. Corp. Reorg. Rel. No. 109 (1958), pp. 20, 24–26, 30, 35.

II

As we have shown in Point I, there are serious doubts of the correctness of the decision below even accepting the basic scheme of distribution as previously formulated by the court—*i.e.*, with Columbia's claims not being rejected entirely and being subordinated only to the public creditors of the system (treated as creditors of Inland) and not to the public stockholders. The petition in No. 774 for the Allen Committee (representing the public stockholders of American) in addition challenges that basic scheme and contends that Columbia's claims should have been rejected outright in favor of the public stockholders who were equally injured by Columbia's unconscionable conduct. That petition, we believe, also raises questions of substantial merit.

The scheme of distribution embodied in the present plan was developed in this way: At a time when the assets of Inland were not sufficient to pay even the direct public creditors of Inland—so that subordination of Columbia was thought to have the same effect as rejection of its claims—the court of appeals, rather than resolve "academic" questions of its power to reject the claims (187 F. 2d 813, 815; Allen 31), directed that a proposed plan rejecting Columbia's claims be amended by limiting the remedy to subordination. 151 F. 2d 461, 469–470 (Allen 27–28). When it later appeared that the assets were more than sufficient for the direct public creditors of Inland, the court held, in accordance with the views of the Commission, that the subordination of Columbia's claims should also extend to

the public creditors of the holding companies, the surplus after payment of Inland's direct creditors being divided between the American creditors and the Kentucky creditors in proportion to the stock interests of those companies in Inland (American, 72.6%, and Kentucky, 26%). The court disagreed with the Commission's further recommendation that equal payments per share be made to the holders of the 1.4% of the Inland stock not held by the holding companies, since it thought those stockholders could not be assimilated to a "creditor" status. 187 F. 2d 813, 817 (Allen 32-33). When, still later, it appeared that the American creditors' 72.6% share of the Inland surplus would more than pay both principal and interest on their claims, the court held (adopting the views of the Commission) that the balance of that share should go to the Kentucky creditors rather than revert to Columbia. 211 F. 2d 381, 384. The court below has now held, as indicated in Point I, that the Kentucky creditors' participation should be limited to principal and that the balance should go to Columbia.

This order of distribution is, of course, premised upon the nonrejection of Columbia's claims. If, as the Allen Committee contends, Columbia's claims were rejected and the net Inland assets (after payment of the direct creditors of Inland) were distributed strictly according to the stock holdings in Inland, 72.6% of the Inland surplus would go to American, 26% to Kentucky, and 1.4% to the public stockholders of Inland. The 72.6% share going to American would be more than enough to pay the public creditors of American (who are also paid in full under the present

plan) and, with Columbia's claims as a creditor of American (as well as of Inland) also being rejected, the balance would go to the American stockholders. Since the court below has never expressly considered the relative equities of Columbia and of the public stockholders (in part at least because of the Topsy-like development of the distribution scheme), there is considerable merit to the American stockholders' contentions, and they ought also, we believe, to be reviewed by this Court.

In addition to the main contention of the Allen petition that Columbia's claims should be rejected entirely, there is a further question whether, if the claims are not rejected, the court below has power to subordinate those claims, at least in part, to stock interests as well as to creditor interests. This question has particular application to the rights of the public holders of 1.4% of the Inland stock, who are unrepresented in this proceeding. When the court held that Columbia should be subordinated to the claims of the public creditors of the holding companies (who were to participate in proportion to their companies' holdings of Inland stock), the Commission recommended that they should also be subordinated to the claims of the 1.4% stockholders to the extent of an equivalent per share distribution, pointing out that the equities of private owners of Inland stock were at least equal to those of creditors of the corporate owners of Inland stock. The court refused so to subordinate the claims to the Inland stockholders because the "holders of such stock were in no sense creditors." 187 F. 2d 813, 817. However, no creditor status is necessary

for application of the doctrine of subordination. See *Taylor* v. *Standard Gas & Electric Co.*, 306 U.S. 307, where subordination to preferred stock was required. The stockholders, as well as the creditors, were found to have been wronged by Columbia's conduct and the compensation of Columbia prior to any compensation of the injured stockholders is an anomaly which, we believe, is not required if the equitable power of subordination is to be given its full significance.*

The refusal of the court below to recognize the equities of the stockholders is particularly unfair in its effect upon the unrepresented public holders of 1.4% of the Inland stock. Having declined to reject Columbia's claims yet unwilling to see Columbia profit before the creditors of the other injured companies were compensated, the court allowed those creditors to participate in the Inland estate ahead of Columbia. While that solution was obviously equitable as between those creditors and Columbia, it

*The difference between subordination of a claim to stockholders and rejection of the claim is in reality but one of degree and not of kind. Unlimited subordination would be equivalent to rejection, since common stockholders have an unlimited claim. By the device of subordination, however, the court would have the power to limit the extent of the subordination to that appropriate under the circumstances and allow the creditor thereafter to participate—*e.g.*, by limiting the stockholders' prior participation to the amount of damage suffered by them if ascertainable. The original issue price of the stock or its highest market value might, for example, be an appropriate measure of the subordination in a given case. If the power of rejection exists, surely the lesser power of partial subordination also exists and gives to the courts as full power to do equity between injured stockholders and wrongdoing creditors as they have as between injured and wrongdoing creditors.

has had an unexpected effect upon the 1.4% minority stockholders of Inland. The increase in the Inland estate during the reorganization (and since the earlier rulings establishing the order of distribution) has been so great that now the minority Inland stockholders would be entitled to participate if Columbia had not been subordinated at all and had been paid in full on its claims.[10] The blurring of corporate lines in order to prevent Columbia from benefiting ahead of the creditors of the holding companies should not, we submit, be allowed to prejudice the rights of the innocent public stockholders of Inland, and for that reason also we believe that review of the decision below by this Court is appropriate.

[10] The unpaid direct claims against Inland, for both principal and interest and *including* Columbia's claims, totalled $6,752,664 as of December 31, 1957 (See Appendix, *infra*, p. 30). The court's valuation of the Inland estate as of that date was approximately $10,500,000 (see Statement, *supra*, p. 8), thus leaving a substantial equity for the Inland stockholders but for the subordination of Columbia's claims to those of the holding companies' creditors.

CONCLUSION

For the foregoing reasons the petitions for writs of certiorari should be granted.

Respectfully submitted.

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APPENDIX

The claims including interest at the contract rate against Inland, Kentucky and American are, according to the certified balance sheets of the debtors, as follows:

	Principal	Interest to Dec. 31, 1957 [1]	Total claim to Dec. 31, 1957 [1]	Interest to Dec. 31, 1958	Total claim to Dec. 31, 1958
INLAND					
Advances due American	$335,986	$617,206	$953,192	$639,046	$974,[illegible]
Claims of general creditors	10,022		10,022		10,022
6½% First Mortgage Bonds held by Columbia	1,871,064	[2] 2,585,183	4,156,237	[2] 2,687,302	4,[illegible]
7% Second Mortgage Debentures held by Columbia	320,000	614,325	934,325	636,732	[illegible]
Unsecured claims for advances by Columbia	282,313	446,575	698,888	462,976	[illegible]
AMERICAN					
7% Gold Notes held by public	$1,906,100	$2,800,497	$4,705,597	$2,933,854	$4,[illegible]
7% Gold Notes held by Columbia	60,000	115,500	175,500	119,700	[illegible]
6% Demand Notes held by Columbia	552,000	907,808	1,459,808	940,928	[illegible]
Unsecured claims of Columbia	17,301		17,301		17,[illegible]
KENTUCKY					
6½% First Mortgage Bonds publicly held	[3] $1,906,701	$3,571,956	$5,478,657	$3,695,892	$5,[illegible]
6½% Debentures, publicly held	542,000	971,760	1,513,760	1,006,990	1,[illegible]
6½% First Mortgage Bonds held by Columbia	1,685,871	2,974,367	4,660,238	3,083,949	4,[illegible]
6½% Debentures held by Columbia	397,600	712,864	1,110,464	738,706	1,[illegible]
Unsecured claims for advances by Columbia	65,606	116,180	181,786	120,445	[illegible]

[1] This is the date of the reorganization value for the estate adopted by the district court and as of which the Commission made its valuation.

[2] The accountants' certificate attached to the audited balance sheet of Inland as of Dec. 31, 1957 and 1958, referred also to additional interest of $236,018 on distributions denied to Columbia.

[3] The original principal amount of the Kentucky bonds in the hands of public creditors aggregated $2,236,600. During the proceedings a payment, equal to 18% of the principal amount, or $402,[illegible] was made on the bonds. For plan purposes, the trustees have credited against defaulted interest, $72,689.50 and, since subsequent interest has been disallowed, the balance of the payment of $329,[illegible] has been applied in the reduction of the principal amount of bonds.

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